WEDGE WATCH

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A Good Lie?

"A lie never lives to be old."
– Sophocles

Second Quarter 2008 Financial Statistics

DJIA: 11350.01

S&P 500: 1280.00

90-Day T-Bill: 1.73%

30-Yr. T-Bond: 4.52%

One day, amidst the depths of the Great Depression, a gentleman by the name of John Montague appeared in Los Angeles. In relatively short order, this unknown newcomer ingratiated himself to, and captured the imagination of, an assorted cadre of Hollywood icons who regularly frequented the Lakeside Country Club in Burbank. His list of pals included Bing Crosby, Johnny Weissmuller, Howard Hughes, W.C. Fields and comedian Oliver Hardy. Montague, a natural entertainer himself, was said to "entertain the entertainers" with a broad array of natural charms that allowed him to fit perfectly into the stars' orbit of "alcohol, golf, madcap bravado" and machismo.

Montague was a large man, thought to resemble a near perfect blend of Jackie Gleason and Babe Ruth (who he befriended as well). In addition, along with his notable size came physical strength of near gargantuan proportion. In fact, it was reported that he could hoist the famously rotund Hardy well off the ground with a single hand. No small feat given that the comedian often tipped the scales at around 300 pounds. However, it was Montague's remarkable acumen on the golf course that garnered the greatest attention.

John Montague possessed a dazzling repertoire of golf skills, unlike most had ever seen. On the tee box, his legendary strength translated into drives of epic proportion. In fact, according to his biographer, Leigh Montville, Montague "once hit 10 balls from the tee of a 347-yard par-four hole – reaching the green an amazing seven times." Anomalously, his touch and hand-eye coordination rivaled his power. Once, on a bet, he purportedly knocked a bird off a wire from 175 yards away! In addition, he could chip a ball through a slightly opened window without shattering the glass; and, most impressively, on one occasion beat his close pal Bing Crosby, an excellent golfer himself, using only a rake, a shovel and a baseball bat. Montague, however, was far more than just a trick-shot artist and hustler. He was also a scratch player who once tied the Lakeside Club course record with a score of 63. This was an impressive feat given that both Bobby Jones and Walter Hagen, two of the era's preeminent players, had also played there.

There was a distinct peculiarity about Montague however. In addition to the perpetually mysterious air of his persona, he adamantly refused to be photographed. In fact, he shunned any kind of publicity and, incongruously, never entered a professional golf event (though he likely would have been a formidable competitor against any and all comers). His only interest seemed to be the $100 and $200 bets he regularly won at the club. Many, in fact, thought he was a man of obvious wealth, given his stable of rich and famous friends. But as the old saying goes, *you can run but you can't hide*; especially in a town like Hollywood, which thrives on publicity and attention. As a result, Montague's true identity would remain a secret for only so long.

In early 1937, the famous sportswriter Grantland Rice, who had once heralded Montague as "the greatest golfer in the world," called attention to his exploits in one of his frequent and widely-read newspaper columns. Subsequently, *Time* magazine followed suit, surreptitiously snapping a photograph of the unsuspecting Montague. Soon after the magazine hit the newsstands, the "boisterous enigma's" multi-year charade came to a jarring end.

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…Lie

Police in the small town of Oneida, New York were surprised to see a familiar but grainy face staring back at them as they casually perused the article on Montague. The "so-called Sphinx of the Links" was none other than LaVerne Moore, an ex-bootlegger and former minor-league baseball player long wanted for a 1930 armed robbery and brutal assault in the nearby Adirondacks. Extradition and indictment soon followed, setting the stage for "a star-studded legal circus" that turned out to be the most high-profile court battle of its day – the trial of "The Mysterious Montague."

"It isn't what we don't know that gives us trouble; it's what we know that ain't so."
– Will Rogers

Appearances, of course, can be deceiving. This is true in the financial markets as well. Believing, and subsequently buying into, what one thinks he or she sees can *eventually* lead to unanticipated and painful outcomes for investors (especially if a trend has already been heavily exploited by the herd). Consider the following:

As this is written, the price of crude oil has spiked to over US$139 per barrel, seemingly headed for a tripling in price since mid-January of last year. In the last several months alone, the commodity is up over 50% from its January 2008 low. Such price levels and percentage gains were largely unthinkable only a year ago. Remarkably, this price move has transpired against the backdrop of a nasty and still evolving worldwide credit and housing dislocation of unprecedented proportions. Even more surprising, **the price rally to the commodity's recent peak surpassed the gains in internet/tech stocks that preceded the dot.com crash in 2000**. According to *Bloomberg News*, crude rose 694 percent from the November 2001 low of $17.45 per barrel to its recent high. Comparatively, the NASDAQ Composite Index rose 627 percent from the start of its prolific rally in June 1994 to its bubblicious peak in early March of 2000.

The inimitable wordsmith Yogi Berra once said: *"If you ask me a question I don't know, I'm not going to answer it."* Professional investors, however, don't have that luxury. Like it or not, we must attempt to confront the tough questions head on. From that perspective, we'll take a shot at deciphering one of the latest mind benders offered up by Wall Street: **the conundrum that is the oil price surge** (though, as you might imagine, there are no simple explanations for it). We do, however, have suspicions about some of the possible contributing causes - at least at the margin. With the help of our friends at *GaveKal Research*, whose work we'll extensively reference via quotations in the next several paragraphs, let us try to explain.

"And up through the ground came bubblin' crude. Oil that is, black gold, Texas tea."
– Lyrics from the theme song for The Beverly Hillbillies television series (circa 1962)

The conventional wisdom today is that the current commodity boom (which has extended well beyond just crude prices this cycle) is "driven by profound and lasting changes in global supply and demand: China's insatiable appetite for food and energy, geopolitical conflicts in the Middle East, the peaking of global oil reserves (the *Peak Oil* theory), droughts caused by global warming and so on." Such arguments, which seem quite plausible, are also intuitively appealing. However, they say "literally nothing about whether a barrel of oil will soon jump to US$200, stay at US$139 or fall back" below the psychologically important price threshold of US$100, in the months ahead.

Despite the availability of far less spare production capacity than existed over the decade following the mid-1970's, **the near doubling in the price of crude over the last ten months appears distinctly anomalous**; especially given that none of the just-cited fundamental factors has changed materially over that time frame. For example, "the oil markets did not suddenly discover China's oil demand six months ago" so this is unlikely "to explain the more than doubling of prices since November of last year." In fact, *"China's insatiable demand growth, according to research firm ISI, has decelerated from 0.9 million barrels a day (mbd) in 2004 to 0.3mbd in 2007. In the same period, total global demand growth has slowed from 3.6mbd to 0.6mbd*. As a result, demand is now increasing less rapidly than non-OPEC production, which grew by 0.7mbd. With *OPEC* production capacity continuing to grow slowly but surely (i.e., Iraq's production has been restored to its pre-war level in the past year or so), *ISI* calculates that 'the cartel's spare capacity will climb to 5mbd by the 2nd half of 2008.'"

If these statistics, which imply a growing physical supply of crude, are valid, and they've been "broadly endorsed by oil energy analysts, the *International Energy Agency* and *OPEC* itself, whose President described the recent price increase as 'completely crazy,' why are commodity prices," *which in aggregate have increased more over the last five years than at any other time in U.S. history,* "still rising?" The answer articulated in the next several paragraphs may surprise you.

A look at recent price action shows that many commodities are, in actuality, no longer rising. "Rice, wheat and pork are 15 to 35 percent cheaper than they were four months ago, when financial pundits identified Asian and African food riots as the first symptoms of a commodity 'super-cycle' that would drive prices much higher. In addition, industrial metals such as lead, zinc and nickel, whose prices shot up a year ago in response to 'insatiable demand' stories from China, have since plunged by 50 percent or more. In fact, **most major commodity indices would already be in a downtrend, were it not for the dominance of oil."**

Though many investors have been shocked at the price surge of crude over the past year, such price moves in financial and asset-based markets are not unprecedented. In fact, financial market history shows very clearly that "it is quite normal for prices to become completely detached from economic fundamentals." Home prices in once red-hot markets like Southern California, Florida and the United Kingdom "kept rising even after property developers built far more homes than they could possibly sell." In recent years, this same phenomenon played out in the credit and mortgage markets as well; not to mention what happened with the dot-com bubble and the 1980's Japanese real estate bubble (where psychology drove prices well past underlying fundamentals).

The genesis and evolution of financial manias are predictable. According to famed currency investor George Soros, writing in his new book *The New Paradigm for Financial Markets*, they usually follow "some genuinely revolutionary economic event," such as an emerging shortage of oil supply in the face of exploding secular global demand from places like China. "But once such a transformation catches investors' imaginations it turns into a 'fertile fallacy,' and then 'a self-reinforcing market bias.' Hence, its momentum tends to feed on itself" (especially in the global financial markets where short-term performance incentives and speculation have become so profound). "Thus the market moves from the textbook situation in which the balance of demand and supply determines prices to" what Soros calls "a reflexive 'far from equilibrium position,' in which price changes create ever larger imbalances between demand and supply."

For those who vividly remember the 1973-74 Arab Oil Embargo, today's virtual absence of retail shortages and long lines at the gas pump is likely quite perplexing. When the Middle East cut off supply at that time, gas rationing became the norm here in the U.S. Why then, given the unprecedented price surge of crude in recent months and the supposed structural tightness in global supply, is consumer demand not triggering a similar rationing response at the pump? A clean answer, unfortunately, is elusive given the multifaceted dynamics (i.e., currencies, interest rates, foreign subsidies) that help drive the price of commodities. However, a few relevant anecdotes might provide important clues.

According to recent reports from *GaveKal* and *ISI*, "the Persian Gulf is crammed with supertankers chartered by the Iranian and Arab governments to hold inventories of oil they are pumping but cannot sell." This excess physical supply does not, however, mean that "the producers are somehow cheating by storing their oil in tankers or keeping it in the ground." What it appears to suggest though is that "there are few buyers for physical oil cargoes at today's prices." To the contrary, **"there are plenty of (speculative) buyers of pieces of paper linked to the price of oil next month and next year," since the price obviously can only continue going higher** (or so it would seem).

According to Mark Lapolla of investment research boutique *Sixth Man Research*, the recent U.S. Senate hearings on commodity market speculation brought "the role of passive indexation in the commodity markets front and center on the national stage." Testifying there, George Soros, who attributes a large part of his legendary investing success to carefully tracking bubbles, said that although there are distinct fundamental reasons for the rise in oil prices (i.e., escalating costs for drilling/discovery, waning supply), **a bubble has been "superimposed" by pension-fund managers' move to commodities as an asset class**. He stated that as the initial mispricing in commodities disappeared, financial institutions continued to pile in because commodities turned out to be more profitable than other assets – a "classic case of misconception that is liable to be self-reinforcing in both directions." *He likened the investment flood into commodity indexes to the craze for portfolio insurance that led to the stock market crash of 1987,* further intimating that commodities "should be disqualified as an asset class for *ERISA* institutions."

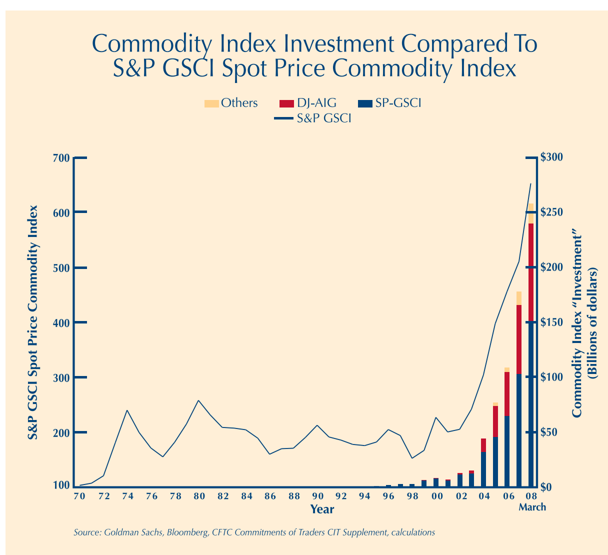
Soros isn't the only high profile investor/expert attributing the recent surge in crude prices to speculation. *OPEC* Secretary-General Abdalla Salem el-Badri stated last month that hedge funds "are more influential in the doubling of prices in the past year than any shortage of supply," though his perspective may be less than objective. Echoing that assertion, St. Croix-based hedge fund manager Michael W. Masters, who also testified during the recent Senate hearings in Washington, gave extensive and detailed testimony attributing the shocking price spikes across numerous commodities to **"a demand shock coming from a new category of participant in the commodities futures markets: institutional investors" such as pension funds, sovereign wealth funds, university endowments, etc.** He emphatically made the case that "collectively, these investors," which he dubs *Institutional*

Speculators, "now account on average for a larger share of outstanding commodities futures contracts than any other market participant." He went on to highlight that, "five years ago, commodity index speculators were a tiny fraction of the commodities futures markets. *Today, in many commodities futures markets, they are the single largest force*."

"There are two times in a man's life when he should not speculate. The first time is when he cannot afford to. The second time is when he can."
– Mark Twain

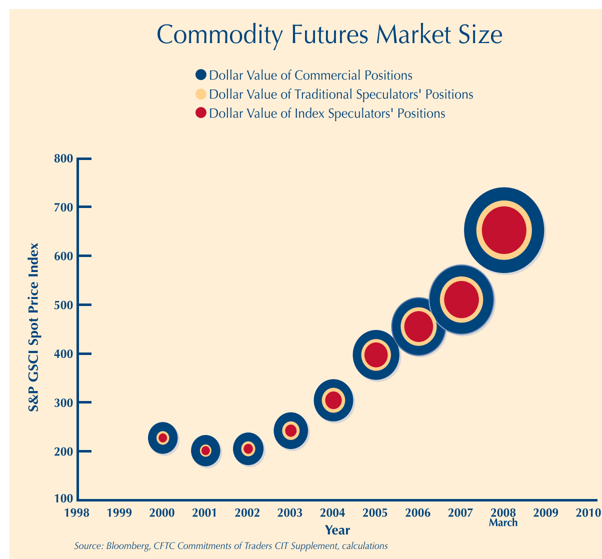
Chart 1, from Michael Masters' Senate testimony, "shows that assets allocated to commodity index trading strategies have risen from $13 billion at the end of 2003 to $260 billion as of March 2008, and the prices of the 25 commodities that compose these indices have risen by an average of 183% in those five years. Over the same five-year period, *Index Speculator* demand for petroleum futures has increased by 848 million barrels," an amount nearly "equal to the increase in demand from China" over the same period. "In addition, *Index Speculators* have stockpiled, via the futures market, the equivalent of 1.1 billion barrels of petroleum, effectively adding eight times as much oil to their own stockpile as the United States has added to the Strategic Petroleum Reserve over the last five years." Adding more fuel to the fire, recent reports show traders who could be counted as "speculators" hold nearly 70% of all outstanding West Texas Intermediate Crude (WTI) futures contracts (though the Commodity Futures Trading Commission [CFTC] refutes that).

Chart 1



Amidst his statistics-laden testimony, Masters called attention to another little understood and important dynamic about today's commodity market backdrop: speculator demand for commodities "is not concerned with price" as "they will buy as many futures contracts as they need, at whatever price necessary," until all of the money they've allocated is "put to work." This insensitivity to price, per an asset allocation-driven mentality, "multiplies their impact on commodity markets." In addition, it's important to note that **"commodities futures markets are much smaller than the capital markets, so multi-billion dollar allocations to commodities markets will have far greater impact on prices."** During the first quarter of 2008, see **Chart 2**, "*Index Speculators* flooded the markets with $55 billion in just the first 52 trading days" of the year. "That's an increase in the dollar value of outstanding futures contracts of more than $1 billion per trading day." Needless to say, it's hard to imagine such a flood of "artificial," non-fundamental demand wouldn't have an outsized impact on prices.

Chart 2



The theoretical argument underpinning *Peak Oil* is intuitively appealing (and *the relatively massive two-decade underinvestment in global production and refinery infrastructure does nothing to refute it*). However the theory does not take into account the occasional and typically severe demand response to abnormally high prices. This important oversight may be of particular relevance in the months ahead. A look back in time explains why.

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In the aftermath of the 2nd oil shock of the late 1970's, according to *GaveKal*, "demand for petroleum products entered a prolonged and steep negative growth, even while total primary energy demand kept on rising." More specifically, **"after the oil shocks of the 1970's – it took 10 years for aggregate petroleum demand to recover to historical levels. It took 20 years for U.S. total petroleum demand to reach its historical high of 1979 and 14 years for Japan."** As for Europe, *demand never again met levels of maximum consumption reached in 1979,* and today only stands on par with what it consumed in 1974.

Despite the staggering spike in crude prices year-to-date, there is nothing that says the commodity can't go even higher (as we know, markets tend to overshoot, sometimes to an extreme). However, with gas prices in some domestic markets having recently pierced the $4 per gallon level, the consumer squeeze here in the U.S. appears very much on. In fact, according to the *The Wall Street Journal,* "spending on fuel as a share of wage income has shot above 6%. That exceeds the percentage seen during the 1974-75 and 1990-91 oil-price shocks and approaches the 7% to 8% seen during the 1980-81 price surge. Comparing the rise in fuel spending to income growth, which has been especially weak in recent years, **the current shock is far worse than any of the three prior" shocks**. *Against this backdrop, if crude prices continue to rise unabated, a severe negative demand response would seem almost assured.*

We have little doubt that an inevitable resumption in global GDP growth will fundamentally tighten the supply/demand balance for crude *(at least until new supplies and/or alternatives eventually begin to proliferate)*. However, a period of slower growth and, more likely in our opinion, global economic contraction will transpire first. *Against that backdrop, the true price of crude, like the true identity of "The Mysterious Montague," will likely be revealed.* ***Stay tuned.***

Index	06/30/08 Price	2nd Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	11350.01	-7.4%	-14.4%
S&P 500	1280.00	-3.2	-12.8
Value Line Composite	372.02	-4.7	-15.5
American Exchange Comp.	2232.05	0.0	-7.4
NASDAQ Composite	2292.98	0.6	-13.5

*Does not include dividend income.

Fixed Income

Are We There Yet?

The vacation driving season is upon us and the generational refrain, "are we there yet?" will be chanted countless times by impatient and excited children occupying the backseat of America's family vehicles this summer. Equally impatient parents will answer "not yet" more times than they care to, as they check signposts along the way to gauge how many miles remain before reaching their vacation destination.

In a similar vein, impatient investors are asking "are we there yet?" with respect to the bottom of the current very painful housing cycle. Unfortunately, most of the evidence suggests that the answer is clearly "not yet." **However, a few signposts <u>may</u> be signaling that quite a bit of the trip is behind us.**

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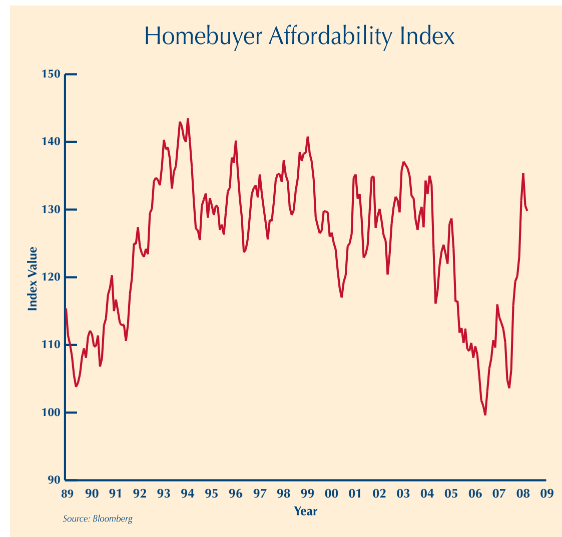
In trying to gauge how far we've come, what signposts should we consider along the way? The central element in the housing "bubble," of course, was a very rapid increase in home prices. Driven by overly easy credit, an expectation developed that home prices would never decline. Now, prices are actually falling, easy credit terms have been removed, and everyone has come to the *realization* that home prices can indeed decline. As it stands now, it would appear that home prices need to fall further to clear the market, given the substantial supply of homes for sale. In certain locations (California), prices have fallen so rapidly that a large percentage of homes being sold are the result of foreclosure. This may imply that for a certain segment of the housing market, a possible floor could be in sight. *Falling prices and increasing sales are necessary conditions for the housing market to recover.*

Although declining home values are obviously not good for the seller or mortgage holder, they are a plus for the buyer. **Chart 3** shows the monthly homebuyer affordability index. At 100, the index suggests the median-income household can buy the median-priced home with a 20% down payment and a traditional mortgage. Note that affordability (since the 2001 recession) peaked in 2003, about the time home prices began their rapid multi-year increase. Affordability then reached a low point in the middle of 2006, well *before* the "housing bubble" was mainstream news. Since then, affordability has increased to levels near those experienced during 2001 – 2004. Going forward, it will be interesting to see if the current trend holds, because the recent rise in interest rates will likely hurt affordability.

Chart 3



Another signpost, emerging from among the worst areas of the housing disaster, seems to be improving. **The 30-day delinquency rates for a number of subprime mortgage-backed securities pools (that form the basis of the now-infamous ABX indices) have stabilized in recent months. In fact, some 30-day delinquency rates have actually *declined.*** Even more encouraging is that these delinquency rate trends are based on *current* balances, instead of original balances. Having followed this data for some time, we've been puzzled that, despite all of the headlines, write-downs and negative commentary on the subject, the *cumulative losses* incurred by these pools (so far) are only around 3%. To be sure, these cumulative losses will rise dramatically from current levels due to the lag time between delinquency, foreclosure and ultimate sale. **Needless to say, the eventual magnitude of losses on these (and many other) mortgage pools will have a huge impact on how accurate the mark-to-market losses have been for so many banks, brokerage firms, monoline insurers and other investors.**

What are the implications for fixed income markets of these admittedly small positive developments in the housing market? Any sign of stabilization in housing will likely go a long way toward helping restore confidence to the various spread sectors. Liquidity will then return, eventually leading to narrower risk premiums, particularly for financial institutions' debt and mortgage-backed securities. *Although apparently **we're not there yet**, these signposts may indicate progress is being made.*

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